Table of Contents

difference between this increased tax rate in 2004 and the actual rate of 70% in 2003 is primarily a result of less stock-based compensation as a percentage of income before income taxes in 2004 compared to 2003.

Our effective tax rate beginning in the first quarter of 2005, and for the foreseeable future thereafter, is expected to be significantly lower than our effective tax rate of 39% in 2004. This is primarily because proportionately more of our earnings in 2005 compared to 2004 are expected to be recognized by our Irish subsidiary, and such earnings are taxed at a lower statutory tax rate (12.5%) than in the U.S. (35.0%). However, if future earnings recognized by our Irish subsidiary are not as proportionately great as we expect, our effective tax rate may not decrease as significantly, if at all. In addition, our provision for income taxes will be significantly reduced in the first quarter of 2005 as a result of disqualifying dispositions that occurred during that period. However, for the foreseeable future thereafter, we do not expect further significant reductions to our provision for income taxes as a result of disqualifying dispositions that may occur after the first quarter of 2005 related to incentive stock options currently outstanding. Furthermore, we do not expect to grant a significant number of incentive stock options in the foreseeable future. For additional discussion regarding the accounting for disqualifying dispositions on incentive stock options, see Critical Accounting Policies and Estimates included elsewhere in this Form 10 K.

Our provision for income taxes increased to $241.0 million or an effective tax rate of 70% during 2003, from $85.3 million or an effective tax rate of 46% during 2002. The increase in our provision for income taxes primarily resulted from an increase in Federal and state income taxes, driven by higher taxable income year over year. Our effective tax rate is higher than the statutory rate because, in arriving at income before income taxes, we include in our costs and expenses significant non-cash expenses related to stock-based compensation, which are recognized for financial reporting purposes, but did not reduce our provision for income taxes during these years. The increase in our effective tax rates in 2003 was primarily the result of an increase in stock-based compensation amounts.

A reconciliation of the federal statutory income tax rate to our effective tax rate is set forth in Note 12 of Notes to Consolidated Financial Statements included in this Form 10-K.

Quarterly Results of Operations

You should read the following tables presenting our quarterly results of operations in conjunction with the consolidated financial statements and related notes contained elsewhere in this Form 10-K. We have prepared the unaudited information on the same basis as our audited consolidated financial statements. You should also keep in mind, as you read the following tables, that our operating results for any quarter are not necessarily indicative of results for any future quarters or for a full year.

Table of Contents

The following table presents our unaudited quarterly results of operations for the eight quarters ended December 2004. This table includes all adjustments, consisting only of normal recurring adjustments, that we consider necessary for fair presentation of our financial position and operating results for the quarters presented. Both seasonal fluctuations in Internet usage and traditional retail seasonality have affected, and are likely to continue to affect, our business. Internet usage generally slows during the summer months, and commercial queries typically increase significantly in the fourth calendar quarter of each year. These seasonal trends have caused and will likely continue to cause, fluctuations in our quarterly results, including fluctuations in sequential revenue growth rates. Prior to the second quarter of 2004, these seasonal trends may have been masked by the substantial quarter over quarter growth of Internet traffic focused on commercial transactions and ultimately by the substantial quarter over quarter growth in our revenues.

	Quarter Ended							
	Mar 31, 2003	Jun 30, 2003	Sep 30, 2003	Dec 31, 2003	Mar 31, 2004	Jun 30, 2004	Sep 30, 2004	Dec 31, 2004
	(in thousands, except per share amounts) (unaudited)							
Consolidated Statements of Income Data:								
Revenues	$248,618	$311,199	$393,942	$512,175	$651,623	$700,212	$805,887	$1,031,501
Costs and expenses:								
Cost of revenues	87,195	117,401	170,390	250,868	315,398	326,377	362,099	453,779
Research and development (1)	12,505	17,492	32,774	28,457	35,019	45,762	57,409	87,442
Sales and marketing	17,767	24,822	36,575	41,164	47,904	56,777	65,512	76,107
General and administrative	10,027	12,535	13,853	20,284	21,506	25,577	40,774	51,843
Stock-based compensation (2)	36,418	34,165	73,794	84,984	76,473	74,761	67,981	59,531
Non-recurring portion of settlement of disputes with Yahoo	—	—	—	—	—	—	201,000	—
Total costs and expenses	163,912	206,415	327,386	425,757	496,300	529,254	794,775	728,702
Income from operations	84,706	104,784	66,556	86,418	155,323	170,958	11,112	302,799
Interest income, expense and other, net	(47)	766	464	3,007	300	(1,498)	3,866	7,374
Income before income taxes	84,659	105,550	67,020	89,425	155,623	169,460	14,978	310,173
Provision (benefit) for income taxes	58,859	73,382	46,594	62,171	91,650	90,397	(37,005)	106,073
Net income	$ 25,800	$ 32,168	$ 20,426	$ 27,254	$ 63,973	$ 79,063	$ 51,983	$ 204,100
Net income per share:								
Basic	$ 0.20	$ 0.24	$ 0.14	$ 0.19	$ 0.42	$ 0.51	$ 0.25	$ 0.78
Diluted	$ 0.10	$ 0.12	$ 0.08	$ 0.10	$ 0.24	$ 0.30	$ 0.19	$ 0.71

(1) The results for the quarters ended September 30, 2003 and December 31, 2004 include $11.6 million and $10.4 million of in-process research and development expense related to acquisitions.

(2) Stock-based compensation, consisting of amortization of deferred stock-based compensation and the reassessed values of options issued to non-employees for services rendered, is allocated in the table that follows. Stock-based compensation in any quarter is affected by the number of grants in the current and prior quarters, and the difference between the values of the underlying stock determined by the board of directors on the date of grant and the reassessed values used for financial accounting purposes for stock options granted prior to the date of our initial public offering. After the initial public offering, options have been granted at exercise prices equal to the fair market value of the underlying stock on the date of grant. The use of the accelerated basis of amortization results in significantly greater stock-based compensation in the first year of vesting compared to subsequent years.

	Quarter Ended							
	Mar 31, 2003	Jun 30, 2003	Sep 30, 2003	Dec 31, 2003	Mar 31, 2004	Jun 30, 2004	Sep 30, 2004	Dec 31, 2004
	(in thousands, except per share amounts) (unaudited)							
Cost of revenues	$ 1,452	$ 1,361	$ 3,008	$ 2,736	$ 5,076	$ 2,546	$ 1,996	$ 1,696
Research and development	19,423	18,814	43,878	56,262	46,265	45,836	42,120	35,310
Sales and marketing	7,618	7,093	15,819	14,077	14,146	13,431	11,580	10,292
General and administrative	7,925	6,897	11,089	11,909	10,986	12,948	12,285	12,233
	$ 36,418	$ 34,165	$ 73,794	$ 84,984	$ 76,473	$ 74,761	$ 67,981	$ 59,531

Table of Contents

The following table presents our unaudited quarterly results of operations as a percentage of revenues for the eight quarters ended December 31, 2004.

	Quarter Ended							
	Mar 31, 2003	Jun 30, 2003	Sep 30, 2003	Dec 31, 2003	Mar 31, 2004	Jun 30, 2004	Sep 30, 2004	Dec 31, 2004
As Percentage of Revenues:								
Revenues	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Costs and expenses:								
Cost of revenues	35.1	37.7	43.3	49.0	48.4	46.6	44.9	44.0
Research and development (1)	5.0	5.6	8.3	5.5	5.4	6.5	7.1	8.5
Sales and marketing	7.2	8.0	9.3	8.0	7.4	8.1	8.1	7.4
General and administrative	4.0	4.0	3.5	4.0	3.3	3.7	5.1	5.0
Stock-based compensation (2)	14.6	11.0	18.7	16.6	11.7	10.7	8.5	5.8
Non-recurring portion of settlement of disputes with Yahoo	—	—	—	—	—	—	24.9	—
Total costs and expenses	65.9	66.3	83.1	83.1	76.2	75.6	98.6	70.7
Income from operations	34.1	33.7	16.9	16.9	23.8	24.4	1.4	29.3
Interest income, expense and other, net	(0.0)	0.2	0.1	0.6	0.1	(0.2)	0.5	0.7
Income before income taxes	34.1	33.9	17.0	17.5	23.9	24.2	1.9	30.0
Net income	10.4%	10.3%	5.2%	5.3%	9.8%	11.3%	6.5%	19.8%

(1) The results for the quarters ended September 30, 2003 and December 31, 2004 include $11.6 million and $10.4 million of in-process research and development expense related to acquisitions.

(2) Stock-based compensation, consisting of amortization of deferred stock-based compensation and the reassessed values of options issued to non-employees for services rendered, is allocated in the table that follows. Stock-based compensation in any quarter is affected by the number of grants in the current and prior quarters, and the difference between the values of the underlying stocks determined by the board of directors on the date of grant and the reassessed values used for financial accounting purposes for stock options granted prior to the date of our initial public offering. After the initial public offering, options have been granted at exercise prices equal to the fair market value of the underlying stock on the date of the grant. The use of the accelerated basis of amortization results in significantly greater stock-based compensation in the first year of vesting compared to subsequent years.

	Quarter Ended							
	Mar 31, 2003	Jun 30, 2003	Sep 30, 2003	Dec 31, 2003	Mar 31, 2004	Jun 30, 2004	Sep 30, 2004	Dec 31, 2004
Cost of revenues	0.6%	0.4%	0.8%	0.5%	0.8%	0.4%	0.3%	0.2%
Research and development	7.8	6.1	11.1	11.0	7.1	6.5	5.2	3.4
Sales and marketing	3.0	2.3	4.0	2.8	2.1	1.9	1.5	1.0
General and administrative	3.2	2.2	2.8	2.3	1.7	1.9	1.5	1.2
	14.6%	11.0%	18.7%	16.6%	11.7%	10.7%	8.5%	5.8%

Liquidity and Capital Resources

In summary, our cash flows were:

	Year Ended December 31,		
	2002	2003	2004
		(in thousands)	
Net cash provided by operating activities	$ 155,265	395,445	$ 977,044
Net cash used in investing activities	(109,717)	(313,954)	(1,901,356)
Net cash provided by (used in) financing activities	(5,473)	8,090	1,194,618

As a result of the completion of our initial public offering in August 2004, we raised $1,161.1 million of net proceeds. At December 31, 2004, we had $2,132.3 million of cash, cash equivalents and marketable securities, compared to $334.7 million and $146.3 million at December 31, 2003 and 2002 respectively. Cash equivalents

Table of Contents

and marketable securities are comprised of highly liquid debt instruments of U.S. corporations, municipalities in the U.S. and the U.S. government and its agencies. Note 2 of Notes to Consolidated Financial Statements included as part of this Form 10 K describes further the composition of our marketable securities.

Our principal sources of liquidity are our cash, cash equivalents and marketable securities, as well as the cash flow that we generate from our operations. At December 31, 2004 and December 31, 2003, we had unused letters of credit for approximately $14.4 million and $12.2 million. We believe that our existing cash, cash equivalents, marketable securities and cash generated from operations will be sufficient to satisfy our currently anticipated cash requirements through at least the next 12 months. Our liquidity could be negatively affected by a decrease in demand for our products and services. In addition, we may make acquisitions or license products and technologies complementary to our business and may need to raise additional capital through future debt or equity financing to the extent necessary to fund any such acquisitions and licensing activities. Additional financing may not be available at all or on terms favorable to us.

Cash provided by operating activities in 2004 primarily consisted of net income adjusted for certain non-cash items including depreciation, amortization, stock-based compensation, tax benefits from exercise of warrants and other item, the non-recurring portion of our settlement of disputes with Yahoo and the effect of changes in working capital and other activities. Cash provided by operating activities in 2004 was $977.0 million and consisted of net income of $399.1 million, adjustments for non-cash items of $831.1 million and offset by $253.2 million used in working capital and other activities. Adjustments for non-cash items primarily included $278.7 million of stock-based compensation, $191.6 million of tax benefits from exercise of warrants and other, which contributed to a net increase in income taxes receivable on our balance sheet and which lowered the amount of income taxes we paid in 2004, and $201.0 million related to the non-recurring portion of the settlement of disputes with Yahoo. Working capital activities primarily consisted of a net increase in income taxes receivable and deferred income taxes of $125.2 million primarily due to tax benefits resulting from the exercises of warrants, certain stock-based compensation charges and disqualifying dispositions on incentive stock options. In addition, working capital activities consisted of an increase of $156.9 million in accounts receivable due to the growth in fees billed to our advertisers.

Cash provided by operating activities in 2003 was $395.4 million and consisted of net income of $105.6 million, adjustments for non-cash items of $296.0 million and $6.2 million used by working capital and other activities. Working capital and other activities primarily consisted of an increase of $90.4 million in accounts receivable due to the growth in fees billed our advertisers and an increase of $58.9 million in prepaid revenue share, expenses and other assets, due primarily to an increase of $35.5 million related to prepaid revenue share, as a result of several significant prepayments made in the fourth quarter of 2003, as well as an increase of $11.0 million of restricted cash relating to our operating leases. This was partially offset by an increase of $74.6 million in accrued revenue share due to the growth in our AdSense programs and the timing of payments made to our Google Network members and an increase of $31.1 million in accrued expenses and other liabilities primarily due to an increase in annual bonuses as a result of the growth in the number of employees. These bonuses were paid in the first quarter of 2004.

Cash provided by operating activities in 2002 was $155.3 million and consisted of net income of $99.7 million, adjustments for non-cash items of $50.6 million and $5.0 million provided by working capital and other activities.

As we expand our business internationally, we may offer payment terms to certain advertisers that are standard in their locales, but longer than terms we would generally offer to our domestic advertisers. This may increase our working capital requirements and may have a negative effect on cash flow provided by our operating activities. In addition, we expect that, now that we have become a public company, our cash-based compensation per employee will likely increase (in the form of variable bonus awards and other incentive arrangements) in order to retain and attract employees.

Table of Contents

In addition, new accounting rules will require that cash benefits resulting from the tax deductibility of increases in the value of equity instruments issued under share-based payment arrangements be included as part of cash flows from financing activities rather than from operating activities. This change in methods will likely have a significant negative effect on our cash provided by operating activities in periods after adoption of these new rules. See Effect of a Recent Accounting Pronouncement included elsewhere in this Form 10 K.

Cash used in investing activities in 2004 of $1,901.4 million was attributable to net purchases of marketable securities of $1,523.5 million, capital expenditures of $319.0 million and cash consideration used in acquisitions and other investments of $58.9 million. Cash used in investing activities in 2003 of $314.0 million was attributable to capital expenditures of $176.8 million, net purchases of marketable securities of $97.2 million and net cash consideration used in acquisitions of $40.0 million. Cash used in investing activities in 2002 of $109.7 million was primarily attributable to net purchases of marketable securities of $72.6 million and capital expenditures of $37.2 million.

Capital expenditures are mainly for the purchase of information technology assets. In order to manage expected increases in Internet traffic, advertising transactions and new products and services, and to support our overall global business expansion, we will continue to invest heavily in data center operations, technology, corporate facilities and information technology infrastructure. We expect to spend over $500 million on property and equipment, including information technology infrastructure comprised primarily of production servers and network equipment, to manage and grow our operations during 2005.

In addition, cash expenditures for acquisitions and other investments in 2005 may exceed those incurred in 2004. Through these acquisitions and investments, we acquire engineering teams and technologies that we believe will help us expand and grow our business.

Cash provided by financing activities in 2004 of $1,194.6 million was due primarily to net proceeds from the initial public offering of $1,161.1 million. Costs related to our initial public offering were approximately $41.0 million. Cash provided by financing activities in 2003 of $8.1 million was due to proceeds from the issuance of common stock pursuant to stock option exercises of $15.5 million, net of repurchases, offset by repayment of equipment loan and lease obligations of $7.4 million. Cash used in financing activities in 2002 of $5.5 million was due to repayment of equipment loan and capital lease obligations of $7.7 million, partially offset by proceeds from the issuance of common stock pursuant to stock option exercises of $2.3 million, net of repurchases.

Contractual Obligations

	Payments due by period				
	Total	Less than 12 months	13-48 months	49-60 months	More than 60 months
			(in millions) (unaudited)		
Guaranteed minimum revenue share payments	$462.9	$ 230.0	$232.9	$ —	$ —
Capital lease obligations	2.0	2.0	—	—	—
Operating lease obligations	235.8	21.3	86.6	56.7	71.2
Purchase obligations	70.5	17.9	47.4	5.2	—
Other long-term liabilities reflected on our balance sheet under GAAP	24.8	7.7	8.9	2.2	6.0
Total contractual obligations	$796.0	$ 278.9	$375.8	$64.1	$ 77.2

Table of Contents

Guaranteed Minimum Revenue Share Payments

In connection with our AdSense revenue share agreements, we are periodically required to make non-cancelable guaranteed minimum revenue share payments to a small number of our Google Network members over the term of the respective contracts. Under our contracts, these guaranteed payments can vary based on our Google Network members achieving defined performance terms, such as number of advertisements displayed or search queries. In some cases, certain guaranteed amounts will be adjusted downward if our Google Network members do not meet their performance terms and, in some cases, these amounts will be adjusted upward if they exceed their performance terms. The amounts included in the table above assume that the historical upward performance adjustments with respect to each contract will continue, but do not make a similar assumption with respect to downward adjustments. We believe these amounts best represent a reasonable estimate of the future minimum guaranteed payments. Actual guaranteed payments may differ from the estimates presented above. To date, total advertiser fees generated under these AdSense agreements have exceeded the total guaranteed minimum revenue share payments. Five of our Google Network members account for approximately 85% of the total future guaranteed minimum revenue share payments and 10 of our Google Network members account for 96% of these payments. At December 31, 2004, our aggregate outstanding non-cancelable minimum guarantee commitments totaled $462.9 million and these commitments are expected to be settled through 2007.

In addition, in connection with some other AdSense agreements, we have agreed to make an aggregate of $7.7 million of minimum revenue share payments through 2006. This amount is not included in the above table since we generally have the right to cancel these agreements at any time. Because we sometimes cancel agreements that perform poorly, we do not expect to make all of these minimum revenue share payments.

Capital Lease Obligations

At December 31, 2004, we had capital lease obligations of $2.0 million (comprised of $1.9 million of principal and approximately $100,000 of interest) related to several of our equipment leases. These amounts will come due under the terms of the arrangements at various dates through October 2005.

Operating Leases

During 2003, we entered into a nine-year sublease for our headquarters in Mountain View, California. According to the terms of the sublease, we will begin making payments in April 2005 and payments will increase at 3% per annum thereafter. We recognize rent expense on our operating leases on a straight-line basis as of the commencement of the lease. The lease terminates on December 31, 2012; however, we may exercise two five- year renewal options at our discretion. We have an option to purchase the property for approximately $172.4 million, which is exercisable in 2006

In addition, we have entered into various other non-cancelable operating lease agreements for our offices and certain of our data centers throughout the U.S. and internationally with original lease periods expiring between 2005 and 2016. We recognize rent expense on our operating leases on a straight-line basis at the commencement of the lease. Certain of these leases have free or escalating rent payment provisions. We recognize rent expense under such leases on a straight-line basis over the term of the lease.

Purchase Obligations

Purchase obligations in the above table represent non-cancelable contractual obligations at December 31, 2004. In addition, we had $32.7 million of open purchase orders for which we have not received the related services or goods at December 31, 2004. This amount is not included in the above table since we have the right to cancel the purchase orders upon 10 days notice prior to the date of delivery. The majority of our purchase obligations are related to data center operations. These non-cancelable contractual obligations and open purchase orders amounts do not include payments we may be obligated to make to vendors upon their attainment of milestones under the related agreements.

Table of Contents

Off-Balance Sheet Entities

At December 31, 2004 and 2003, we were not involved with any variable interest entities, as defined by the Financial Accounting Standards Board (FASB) Interpretation No. 46 (Revised 2003), *Consolidation of Variable Interest Entities—An Interpretation of ARB No. 51*, having a significant effect on the financial statements.

Critical Accounting Policies and Estimates

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the U.S. In doing so, we have to make estimates and assumptions that affect our reported amounts of assets, liabilities, revenues and expenses, as well as related disclosure of contingent assets and liabilities. In many cases, we could reasonably have used different accounting policies and estimates. In some cases changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ materially from our estimates. To the extent that there are material differences between these estimates and actual results, our financial condition or results of operations will be affected. We base our estimates on past experience and other assumptions that we believe are reasonable under the circumstances, and we evaluate these estimates on an ongoing basis. We refer to accounting estimates of this type as critical accounting policies and estimates, which we discuss further below. Our management has reviewed our critical accounting policies and estimates with our board of directors.

Stock-Based Compensation

Accounting for Stock-Based Awards to Employees

Prior to the initial public offering, we typically granted stock options at exercise prices equal to or less than the value of the underlying stock as determined by our board of directors on the date of option grant. For purposes of financial accounting, we have applied hindsight within each year or quarter prior to our initial public offering to arrive at reassessed values for the shares underlying these options. After the initial public offering, we have granted options at exercise prices equal to the fair market value of the underlying stock on the date of option grant. There are two measures of value of our common stock that were relevant to our accounting for equity compensation relating to our compensatory equity grants prior to our initial public offering:

- The "board-determined value" is the per share value of our common stock determined by our board of directors at the time the board made an equity grant, taking into account a variety of factors, including our historical and projected financial results, comparisons of comparable companies, risks facing us, as well as the liquidity of the common stock.
- The "reassessed value" is the per share value of our common stock determined by us in hindsight solely for the purpose of financial accounting for employee stock-based compensation.

We recorded deferred stock-based compensation to the extent that the reassessed value of the stock at the date of grant exceeded the exercise price of the option. The reassessed values for accounting purposes were determined based on a number of factors and methodologies. One of the significant methods we used to determine the reassessed values for the shares underlying options is through a comparison of price multiples of our historical and forecasted earnings to certain public companies involved in the same or similar lines of business. The market capitalizations of these companies increased significantly from January 2003 through July 2004 which contributed significantly to the increase in the reassessed values of our shares. We also considered our financial performance and growth, primarily since January 2003. Our revenue and earnings growth rates contributed significantly to the increase in the reassessed values of our shares. The reassessed values of our shares increased more significantly in dollar and percentage terms in earlier periods compared to later ones which are reflective of the related revenue and earnings growth rates. We also retained third party advisors to provide two contemporaneous valuation analyses since January 2003 and used this information to support our own valuation analyses. Please note that these reassessed values are inherently uncertain and highly subjective. If we had made different assumptions, our deferred stock-based compensation amount, stock-based compensation expense, in-

Table of Contents

process research and development expense, net income, net income per share and recorded goodwill amounts could have been significantly different.

The table below shows the computation of deferred stock-based compensation amounts arising from restricted shares, restricted stock units and unvested stock options granted to employees for each of the three month and annual periods set forth below:

	Three Months Ended					Three Months Ended				
	March 31, 2003	June 30, 2003	Sept. 30, 2003	Dec. 31, 2003	2003 Total	March 31, 2004	June 30, 2004	Sept. 30, 2004	Dec. 31, 2004	2004 Total
	(unaudited)	(unaudited)	(unaudited)	(unaudited)		(unaudited)	(unaudited)	(unaudited)	(unaudited)	
Options granted to employees	10,262,100	1,431,552	5,785,185	1,281,895	18,760,732	1,004,780	965,520	635,371	50,904	2,656,575
Weighted average exercise price	$ 0.49	$ 3.30	$ 5.17	$ 9.62		$ 16.27	$ 38.43	$ 77.86	$ 83.45	
Weighted average reassessed or fair market value of underlying stock	$ 13.09	$ 33.99	$ 52.33	$ 75.05		$ 88.13	$ 97.03	$ 85.00	$ 144.11	
Weighted average reassessed or contemporaneously determined deferred stock-based compensation per option	$ 12.60	$ 30.69	$ 47.16	$ 65.43		$ 71.86	$ 58.60	$ 7.14	$ 60.66	
Deferred stock-based compensation related to options (in millions)	$ 129.3	$ 43.9	$ 272.8	$ 83.9	$ 529.9	$ 72.2	$ 56.6	$ 4.5	$ 3.1	$ 136.4
Restricted shares granted to employees	—	120,000	114,999	—	234,999	—	16,175	—	—	16,175
Weighted average reassessed value of restricted shares	$ —	$ 25.96	$ 66.41	$ —		$ —	$ 95.09	$ —	$ —	
Deferred stock-based compensation related to restricted shares (in millions)	$ —	$ 3.1	$ 7.6	$ —	$ 10.7	$ —	$ 1.5	$ —	$ —	$ 1.5
Deferred stock-based compensation related to restricted stock units (in millions)	$ —	$ —	$ —	$ —		$ —	$ —	$ —	$ 12.0	$ 12.0
Deferred stock-based compensation related to option modifications (in millions)	$ —	$ —	$ —	$ 10.8	$ 10.8	$ 3.9	$ —	$ —	$ —	$ 3.9
Total deferred stock-based compensation (in millions)	$ 129.3	$ 47.0	$ 280.4	$ 94.7	$ 551.4	$ 76.1	$ 58.1	$ 4.5	$ 15.1	$ 153.8

The above table does not include options granted at exercise prices equal to the fair market value of the underlying stock at the time of, and subsequent to, the initial public offering. Also, it does not include options granted at exercise prices in excess of the reassessed values of the underlying stock prior to the initial public offering. These options were granted with no intrinsic value and, accordingly, no deferred stock-based compensation has been recorded. Also, the above table does not include restricted shares that were issued in connection with certain business acquisitions nor does it include shares that were fully vested at date of grant.

We have accounted for stock options issued to our employees and directors using the intrinsic value method under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*. The alternative is the fair value method as prescribed by Statement of Financial Accounting Standards No. 123, *Accounting for Stock-based Compensation*. If we had used the fair value method, our net income would have been reduced by approximately $2.4 million and $14.8 million in 2003 and 2004. These amounts are substantially less than the differences the separate application of each of these two methods would have on net income in future periods. This is primarily because the differences between the fair values of options granted prior to our initial public offering determined using the Black Scholes method and the related reassessed intrinsic values on the dates of grant were generally insignificant; whereas

Table of Contents

these differences were, and are expected to continue to be, significant for options granted after the initial public offering. Also, the assumptions we make under the Black Scholes method, such as stock-price volatility, will have a significant effect on the determination of the fair value of options granted after the initial public offering. For instance, beginning in the fourth quarter of 2004, we now base our assumptions about stock-price volatility not only on the stock-price volatility of comparable companies, but also on the historical trading data for the period of time there was a public market for our stock and the implied volatility of publicly traded options to buy and sell our stock. The rate used in the fourth quarter was substantially less than that used in prior periods, which resulted in the determination of a lower fair value for options granted in that quarter. Prior to the fourth quarter, our assumptions about stock price volatility were generally based on the volatility rates of comparable public companies. See Note 1 of Notes to Consolidated Financial Statements, as well as Effect of a Recent Accounting Pronouncement, included elsewhere in this Form 10 K for additional information about stock-based compensation, as well as the anticipated effects on our financial results after our adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment ("SFAS 123R") beginning July 1, 2005.

We recognize compensation expense as we amortize the deferred stock-based compensation amounts on an accelerated basis over the related vesting periods. The table below shows employee and non-employee stock-based compensation expense recognized during 2002, 2003 and 2004. In addition, the table presents the expected stock-based compensation expense for stock options, restricted stock and restricted stock units granted to employees prior to January 1, 2005, for each of the next five years and thereafter, assuming all employees remain employed by us for their remaining vesting periods and without consideration to the additional stock-based compensation we will recognize related to these stock options upon our adoption of SFAS 123R beginning July 1, 2005. For additional discussion regarding this pronouncement, see Effect of a Recent Accounting Pronouncement included elsewhere in this Form 10-K. These amounts are compared to the expense and expected expense we would have recognized had we amortized deferred stock-based compensation on a straight-line basis.

	Stock-based compensation expense Year Ended December 31,								
	2002	2003	2004	2005	2006	2007	2008	2009	Thereafter
					(in millions)				
Accelerated basis	$21.6	$229.4	$278.7	$145.8	$ 70.5	$25.9	$ 5.6	$1.3	$ 0.4
Straight-line basis	$13.3	$120.5	$201.9	$171.4	$150.1	$92.2	$30.7	$5.0	$ 2.2

Accounting for Stock-Based Awards to Non-employees

We measure the fair value of options to purchase our common stock granted to non-employees throughout the vesting period as they are earned, at which time we recognize a charge to stock-based compensation. The fair value is determined using the Black-Scholes option-pricing model, which considers the exercise price relative to the reassessed value (for periods before the initial public offering) or the fair market value (for periods after the initial public offering) of the underlying stock, the expected stock price volatility, the expected life of the option, the risk-free interest rate and the dividend yield. As discussed above, the reassessed value of the underlying stock were based on assumptions of matters that are inherently highly uncertain and subjective. Our assumptions about stock-price volatility are generally based on the volatility rates of comparable publicly held companies for all periods prior to the fourth quarter of 2004. However, beginning in the fourth quarter of 2004, our assumptions also consider the historical trading data for the period of time there was a public market for our stock and the implied volatility of publicly traded options to buy and sell our stock. These rates may or may not reflect our stock-price volatility after we have been a publicly held company for a meaningful period of time. If we had made different assumptions about the reassessed value of our stock or stock-price volatility rates, the related stock-based compensation expense and our net income and net income per share amounts could have been significantly different.